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UNIVERSITY OF TORONTO

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A Better Local Business Tax: The BVT

Richard M. Bird

Abstract

Local governments in Canada primarily tax local businesses through the property tax, often, as in Ontario, by applying heavier effective tax rates on business property. There are, however, better ways to tax local businesses. One such way is through a special type of value-added tax (VAT), called here the "business value tax" (BVT). This tax is distinctly different from the VATs already imposed by the federal government in the form of the Goods and Services Tax (GST) as well as similar VATs imposed by several provinces, such as the Quebec Sales Tax (QST), and the Harmonized Sales Tax (HST) used in Ontario and the Atlantic provinces. In recent years, several countries with VATs like Canada's GST – notably Italy, France, and Japan – have introduced a local business tax along the lines of the BVT.

This paper makes the case for a local business tax. The BVT is better than the discriminatory and heavy real property taxes currently levied on businesses in Ontario and other provinces. Moreover, such a tax would be complementary rather than competitive to VATs like the GST and HST. The paper outlines briefly how a BVT works, shows how it differs from the GST/HST, and discusses the experience with BVT-like taxes in several countries. The paper concludes that a local BVT is economically preferable to other forms of local business tax, administratively feasible, and arguably politically desirable. Such a tax would be especially suitable for large cities and metropolitan regions.

Keywords: local business taxation, VAT, metropolitan finance, Canada, Italy, Japan, France

JEL Codes: H25, H71, H77, F36

A Better Local Business Tax: The BVT

1. The Case For and Against Business Taxes

Economists often disagree with each other. However, most agree that convenient though it may be for local governments to collect taxes from businesses, there are good arguments against this common practice. Such taxes can depress investment and distort economic decisions, and hence reduce economic output and the standard of living. Business taxes may also impose significant costs and barriers to the expansion of new and small firms. The economic case against such taxes is especially strong owing to the mobility of capital between localities. Local competition for business may even result in a "race to the bottom" if business taxes are set so low that the local public sector is smaller than it should be (Wilson 1999).

On the other hand, when local governments can "export" business taxes by shifting part of the tax burden to non-residents (Ballentine and Thirsk 1980), local business taxes may be too high, not only deterring investment but also reducing the accountability of local governments by severing the connection between those who are taxed and those who benefit from the services financed by taxes (Thirsk 1982). Although some recent evidence for Ontario suggests that the net economic effects of changes in business property taxes may not be great (Smart 2012), it seems advisable for local governments to keep local taxes on business as low as possible.

Nevertheless, there is a good case for imposing some local taxes on business. Certain public-sector activities bestow identifiable, cost-reducing benefits on businesses, and those firms can and should be charged for the costs incurred in providing such benefits, ideally, through user charges (Bird and Tsiopoulos 1997). For example, if business waste is more toxic and therefore more costly to remove and dispose of than household waste, an additional charge on those businesses imposing the additional cost is clearly warranted. Similarly, if large trucks impose heavier costs on local roads in terms of wear and tear or the increased cost of building to accommodate them, they should be charged accordingly.

Since a significant fraction of local public expenditure directly benefits businesses, there is a good efficiency case for imposing some local taxes on business to cover unattributable benefits to productive activities (Feehan 1998) – at least up to the point at which businesses, like other local residents, pay for what they get. Kitchen and Slack (1993) estimated that, on average, close to 40 percent of municipal expenditures in eight Ontario cities benefited commercial and industrial activities (although this study also found that that the property taxes levied on business in those cities constituted an even higher share of taxes).

Higher business taxation than warranted on economic grounds is economically distorting, but the associated costs in terms of output forgone are largely hidden from public eyes and must be weighed against the political benefits of the fact that most people find such taxes acceptable, perhaps in the mistaken belief that they are paid entirely by those who own businesses rather than by workers and consumers as well, as is more likely. In addition, taxes that grow automatically as the local economy grows provide a readily accessible source of finance for expanding local infrastructure and service needs. Finally, since local governments that tax business gain directly from business growth, they seem more likely to follow "market-facilitating" policies that encourage such growth. On the whole, the real question is thus not *whether* local governments should tax business – they should, and they will – but rather *how* local taxes on business should be imposed.

2. What is a Good Local Business Tax?

Many forms of local business taxation exist around the world. Among the most common are business income taxes, gross receipts taxes, fixed or proportional taxes (or licences) that vary by type of business and location, local sales taxes (which often fall more on intermediate business activities than on final consumers), and non-residential real property taxes. Other licences and fees unrelated to services provided by the public sector may also be imposed. Some countries impose several forms of business tax at the same level of government, some impose different types of taxes at different levels, and some impose different taxes on different sizes and types of business (Bird 2006).

In Canada, however, matters are simple. Canadian municipalities impose some of the highest property taxes in the world (as a share of GDP), and about half of the yield comes from taxes on commercial and industrial property. Business property is often subject to higher rates than residential property. In many cases, it is also assessed at higher ratios of market value. The result of these practices in the Greater Toronto Area a few years ago was that the average effective tax rate on non-residential property in the mid-2000s was 2.7 times the rate on residential property (Bird, Slack, and Tassonyi 2012).

Table 1 shows several types of local business taxes found around the world, listed in the top row. The left-hand column of the table lists several ways to assess the desirability or feasibility of each of these taxes. Most of the entries in the cells of Table 1 are tentative, since it is impossible to find much empirical evidence on most of these issues and difficult even to make uncontroversial qualitative judgments about them.[1] Moreover, it is unlikely that the cells in the table would be filled out in exactly the same way for different types of local governments – urban, rural; big, small; rich, poor. It is equally unlikely that local mayors, provincial finance ministers, citizens, and businesses would give the same weighting to different criteria. In fact, the main lesson to be learned from Table 1 is that when local governments tax business – if they are to do so at all – they need to be

1. For a more detailed discussion of the taxes and criteria listed in Table 1, see Bird (2006).

Table 1
Evaluating Alternative Local Business Taxes

Criterion	Property Tax (higher than on residential)	Business Income Tax	Sales Tax	Gross Receipts, Franchise, Licences	Business Value Tax
Revenue adequacy	Potentially yes	Unlikely	Yes	Perhaps	Yes
Revenue buoyancy	Some	Yes	Yes	Yes	Yes
Correspondence of payers and beneficiaries	Not high	Not high	Not high	Not high	Yes
Progressivity	Not likely to be high	Largely unknown	No	No	No
Administrative cost	Relatively high (if done well)	Not usually feasible locally	Not high	Feasible, but not cheap to set up properly	Feasible
Compliance costs	Not high	Medium	Low	Moderate	Moderate
Political acceptability	Moderate	Low	Perhaps acceptable	Yes	Perhaps moderate
Local accountability	Not high	Low (depends on rate discretion)	Good	Not high	High
Reduces disparities	No	No	No	No	No
Distortionary impact	Moderate	High	Moderate	High	Low

sensitive both to the institutional context and the prevailing balance of political forces and interests.

All of the approaches to local business taxation set out in Table 1 will work in the sense of producing some revenues for local governments, and some may have sufficient elasticity to allow revenues to keep up with inflationary expenditure needs. However, some (such as gross receipts taxes) do so at the expense of introducing distortions in private investment and production decisions and others (such as business income taxes) are not only difficult to administer at the local level owing to compliance costs, but also discourage rather than encourage the growth of the local business tax base. In the end, the choice usually comes down to imposing higher property taxes on business or imposing some form of sales tax. Since the problems with differential business property tax have recently been explored in depth, especially with respect to Ontario, they are not further discussed here.[2]

2. In addition to Smart (2012) and Bird, Slack, and Tassonyi (2012), see Found, Dachis, and Tomlinson (2013).

The case for local sales taxes has recently been revived in Canada, largely as a possible way to finance urban public infrastructure. Relatively little attention has been paid to the critical question of how such local sales taxes would fit into the existing provincial-municipal fiscal structure, perhaps because such taxes would not fit very well at all. The inspiration for the never-implemented "penny tax" proposal in Canada's Western provinces, for example, was largely the apparent revenue-raising success and public acceptability of special sales taxes in several American cities (Vander Ploeg 2011). However, those taxes were imposed as surcharges on existing local retail sales taxes, which are in turn usually surtaxes on state retail sales taxes. No such local sales taxes exist in Canada, even in the few provinces that still have retail sales taxes. In principle, local retail taxes piggy-backed on a provincial retail tax would be administratively feasible. Yet although such taxes are business taxes in the sense that many business inputs are taxed, they have no benefit rationale (Fox 2012). Moreover, both theoretical and empirical studies suggest that local sales taxes not only distort business decisions and discourage local economic activity, but also weaken the connection between local taxes and local expenditures, and hence reduce the accountability of local governments (Sjoquist and Stoycheva 2012).

Most Canadians now live in provinces with some form of value-added tax (VAT). Recent discussion about financing public transit in the Greater Toronto and Hamilton Area produced two major reports that concluded that a significant share of the funding should come from the provincial Harmonized Sales Tax (HST) (Metrolinx 2013; Transit Panel 2013). Although these reports provide little detail about just how this might work, it appears the idea is simply to divert some HST revenues – for example, those arising from sales of motor fuel in the region – to transit. In effect, the proposal is for a provincial grant financed from an earmarked portion of HST revenues and not for a local tax of any sort.

This is not surprising, since there appears to be no feasible way to impose a VAT at the local level: indeed, apart from Canada's provincial VATs – the HST and (in Quebec) the Quebec Sales Tax (QST), which are almost identical to the federal Goods and Services Tax (GST) – no other country has succeeded in imposing a modern VAT at any level below that of the national government.[3] However, three countries – Italy, Japan, and France – have imposed a rather different form of VAT – called here the business value tax (BVT)[4] – at the local level.

Before discussing the experience of these countries with this tax, the next section will describe this type of tax, as in one sense it is very different from sales taxes like the GST, HST, and QST, which are also VATs,[5] and then explain why the BVT is the best form of local business tax.

3. Brazil and India have regional VATs, but in neither country are they really "modern" VATs, as discussed in Ebrill et al. (2001). For further discussion of sub-national VATs around the world, see Bird (2013).

4. This term was introduced in Bird and Mintz (2000).

5. The story of how these three related (but not identical) VATs have evolved in Canada is told in Bird (2012).

Table 2
BVT vs. HST

	HST	BVT
Base	Consumption	Income
Principle	Destination	Origin
Application	Invoice-credit	Accounts
Timing	Monthly	Annually

3. The Business Value Tax

The HST is a VAT. The BVT is imposed on essentially the same base, but is a different form of VAT, with different economic effects, different political implications, and different administrative characteristics (see Table 2).

A standard VAT – like the GST, HST, and QST – is intended to tax consumption in a particular jurisdiction. Such taxes have usually been introduced to replace other forms of sales taxation – in Canada, a retail sales tax at the provincial level and a manufacturers' sales tax at the federal level. Retail sales taxes, like the pre-HST tax in Ontario, are imposed on sales to "final" consumers, and may seem to tax only final consumption. In fact, however, as numerous studies have shown, a substantial part of their tax base invariably consists of business inputs and capital goods (Kuo, McGirr, and Poddar 1988). A principal reason for moving to the VAT was to reduce the extent to which these consumption taxes – the former federal manufacturers' sales tax was even worse in this respect – were distorting business investment and production decisions (Smart and Bird 2009). The mechanism used to resolve this problem – the invoice-credit system – permits businesses subject to VAT to deduct the VAT they pay on inputs (including purchases of capital goods) from the VAT due on their sales. A VAT thus has the same aim as a retail sales tax: to tax final consumption only; but it does the job better.[6]

Also like the retail sales tax, the (provincial part of the) HST is imposed only on sales to purchasers residing in the province. Sales outside the province are freed from tax (in different ways) under both types of tax because they are based on "destination" – where the buyer lives – rather than on "origin" – where the seller is located. In contrast, income taxes are charged to those who receive the income – the seller – and are thus based on origin rather than destination. As Table 2 indicates, the Business Value Tax (BVT) differs conceptually from a VAT like the HST in several important ways even though, in the end, they are both based on taxing the value added by business.

Businesses add value by combining labour with other purchased inputs. The value added by labour is the cost of labour (wages and salaries), while the value

6. Of course, no VAT does the job perfectly: on the defects in Canada's GST see, for example, Smart (2012b).

added by capital is the cost of capital (both debt and equity). The base of the BVT may be calculated by the subtraction method as sales minus the purchase of inputs, including capital purchases (less depreciation allowances), from other businesses.[7] If all capital purchases were deductible, the base would be equivalent to the tax base of a conventional VAT like the HST.[8] However, since the BVT taxes profits as well as wages, it is a tax on income and not, like the HST, a tax on consumption. Moreover, since it is imposed on an origin rather than a destination basis, it is in effect a tax on production – that is, on both investment and consumption – and not a tax on consumption.

Unlike the HST, BVT also taxes exports (sales outside the jurisdiction), but not imports (purchases from other jurisdictions). BVT is thus clearly a tax on business activities and not a form of sales tax.[9] Finally, as Table 2 indicates, the BVT is also administered differently, being imposed on an annual accounts basis – as required for income tax purposes, subject to some adjustments – rather than on the monthly (or quarterly) invoicing of transactions (sales and purchases) employed with the HST.

Introducing an income-based BVT as a local business tax would improve the current Canadian tax system in at least three ways. First, such a tax would be more neutral – less distorting – than most other forms of local business taxes, such as differentially high property taxes, which discriminate against investment. Second, a BVT would be less susceptible to base erosion because with a larger tax base, the rate required to produce a given level of revenue would be lower. Finally, to the extent that the principal economic rationale for taxing business rests on benefit grounds, a BVT is in effect a generalized user charge and may thus not only be considered to be an equitable way to finance local expenditures but also one that should induce more efficiency and effectiveness in local budgeting and spending.[10]

Any local BVT should clearly be regulated by a provincial statute to ensure, for example, that the tax base is defined uniformly in all localities. Moreover, although municipalities should be able to determine their own tax rate in order to foster accountability, it would seem sensible to allow such discretion only within a range of rates, with a maximum to restrict tax exporting and a minimum to restrain tax

7. This tax base may also be calculated in two other ways. The first is called the addition method, by adding wages to the base of a business income tax (such as the corporate income tax) as usually calculated. The second is to approximate the same result by imposing separate taxes on wages (a payroll tax) and an equivalent tax on net capital income.

8. This brief summary oversimplifies matters in several respects: for a more detailed comparison of business income taxes, conventional VATs, and the BVT, see Bird and McKenzie (2001).

9. Taxing investment and exports, as the BVT does, may not seem to be a particularly good idea. Although few seem bothered by the fact that all income taxes do the same thing, the potential distorting effects provide a strong reason for keeping the tax rate low.

10. The case for increasing reliance on benefit financing at the local level is made in detail in Bird and Slack (2013a).

competition. Finally, there should also be a uniform formula for allocating business value added among localities. Businesses that operate in only one locality would be taxed solely by that jurisdiction. However, when businesses operate in more than one jurisdiction, the tax base would, like that of any income-based tax, need to be allocated according to formula weights based on such factors as payroll, sales (on an origin basis), and capital. Although the design and administration of a BVT are not further discussed here, many of the relevant issues are considered in the following discussion of the emergence of VAT-type local business taxes akin to the BVT in recent years.

4. International Experience with BVT-Like Taxes

VAT was first conceived in Germany and the United States as a way of taxing businesses (Sullivan 1965). It thus seems only fitting that the VAT has re-emerged as a form of local business tax in countries such as Italy, Japan, and France, as well as in several U.S. states.

Local business taxes are obviously most likely to be important in the largest cities, where business activities tend to be concentrated. These are also the local governments that most need revenues to accommodate growth and development (Bird and Slack 2013b). It thus makes sense to give them revenue sources that will grow with the city more automatically than property taxes, but that are at the same time a more stable revenue source – and simpler to administer – than taxes on profits. Moreover, since businesses benefit, directly and indirectly, from many public expenditures, an ideal business tax should help recapture some of these benefits, most of which are more related to the size of business activities than to their profitability.

Table 3 provides a brief overview of some of the "VAT-like" local business taxes currently used. Similar taxes have been proposed in other countries, such as Canada (Alberta 2000) and South Africa (Hunter van Ryneveld 2008), but have not yet been adopted.

The German Trade Tax

The grandfather of all "value-added" local business taxes is the German trade tax, or *gewerbesteuer.* As originally conceived, this tax was levied on the income of all factors of production, although it was not imposed in a very coherent fashion. As often happens, however, over the years the scope of the tax base was eroded so much that its value-added nature was essentially lost. The payroll component of the base was abolished in 1980 and, since 1984, 50 percent of interest on "long-term" debts has been deducted from the base, creating an incentive to use more debt financing and reducing the coherence of the tax. In 1997, the imputed value of buildings and equipment was also excluded from the tax base. Moreover, in practice, Germany has essentially removed the tax from all but very large enterprises.

From time to time, proposals have been made to restore something closer to the original conception of the trade tax in Germany. Most local governments appear to have supported a federal proposal in 1982 to introduce an explicit local

*Table 3: BVT-Like Local Business Taxes**					
Country	**Name of Tax**	**Year introduced**	**Rate**	**Base**	**Comments**
U.S.: Michigan	Modified Gross Receipts Tax	1953	1%	Applied by subtraction method. Since exports are exempt and imports taxed, it is in effect on a destination basis. Most business purchases of goods (but not services) are effectively free of tax.	A state rather than local tax. Originally introduced in 1953; abolished in 1967; re-introduced as Single Business Tax in 1975; replaced in 2007 with present tax. Tax base apportioned on the basis of sales.
U.S.: New Hampshire	Business Enterprise Tax	1993	0.5%	Origin-based, being calculated in effect by the addition method through the apportionment process.	Tax base apportioned by the state's share of the taxpayers' nationwide labour compensation, interest, and dividends; creditable against state corporate income tax.
U.S.: Texas	Margin Tax	2007	Up to 1% depending on size of turnover.	Applied on the least of three bases, ranging from 70% of gross receipts to a quasi-VAT base of revenue less cost of goods sold.	Base is apportioned for multistate businesses on basis of sales.
Italy	IRAP *(Imposta regional a sulle activita produttive)*	1998	3.9%	Subtraction method; capital investment depreciated.	Tax base apportioned on the basis of labour costs.
Hungary	HIPA	1990	Up to 2%, at local discretion	Subtraction method, but only costs of goods sold, material costs, and repackaged services deductible.	Tax base apportioned (for larger taxpayers) by a weighted average of payroll or net assets.
France	Territorial economic contribution *(contribution économique territoriale)*	2010	Up to 1.5%, depending on size of turnover; no local discretion	Subtraction method; equipment expensed, real estate depreciated.	Tax base apportioned according to number of employees.
Japan	Enterprise Tax	2004	0.48%, with some local discretion (e.g., Tokyo rate is 0.504%)	Sum of wages, net interest paid, net rents paid, and taxable profits.	Applies to corporations with capital of more than 100 million yen.

*Germany, although it pioneered this form of tax, is not included in this table because it no longer has such a tax.

Sources: Bird (2003); Gilbert (2010b); Luna, Murray, and Yang (2012); Japan Ministry of Finance (2010); Local Autonomy College (2008); and Neubig, Cline, and Dauchy (2010).

VAT, at an estimated rate of about 3 percent, on top of the federal VAT. In contrast to the federal VAT, however, which is a "normal" invoice-credit consumption-based tax, the proposed local tax was to be imposed on a net income origin basis and, preferably, collected by the addition method (that is, on the sum of payroll, interest, rents, and net profits). In the end, however, this proposal was not accepted, owing largely to business opposition to paying taxes when a firm had no profits.

In part precisely because the tax was sensitive to economic cycles, a later federal Commission for Reform of Municipal Finances considered revisions of the trade tax. Local governments prefer a more input-oriented tax (like the BVT) because it yields more stable revenues. On the other hand, businesses prefer a more profit-oriented levy to reflect their "true income" more closely. To date, no changes have been made in either direction. However, the largely unreformed trade tax continues to be a mainstay of local finance in Germany and has been called "the undisputed dominant corporate tax in Germany" (Kessler and Eicke 2007, 283), because of the substantial revenue it produces, even when few or no corporate income taxes are paid.

The American Experience

Next to Germany, the United States is the pioneer in this field, although, in contrast to the other countries discussed here, most experience with BVT-like taxes in the United States has been at the state rather than at the local level.

Michigan

The first U.S. "business" VAT was introduced in Michigan in 1953 and called a Business Activities Tax. This state (not local) tax was imposed on the difference between a firm's gross receipts and its payments to other firms: in effect, it was a source-based, subtraction-method, income VAT (Hines 2003). Although the initial tax rate was only 0.4 percent, it rose to 0.75 percent before the tax was abolished in 1967 and replaced with a corporate income tax.

In 1975, however, Michigan returned to the VAT model, replacing the corporate income tax with a new Single Business Tax (SBT) initially at a rate of 2.35 percent. The SBT was again essentially a modified VAT, although this time computed through the addition method and measured on the income side as the sum of payments to labour and capital.[11] All persons engaged in business activity were subject to SBT if their gross receipts exceeded $350,000. The tax was computed annually on the basis of net income as reported for federal tax purposes, adjusted by adding such items as compensation, depreciation, and partnership

11. Kleine (2008) suggests that the additive approach was one reason for the unpopularity of the SBT because it led to claims that companies were penalized for increasing employment; on the other hand, Arnold and Ardinger (2004) assert that the additive approach adopted in New Hampshire is one of the main strengths of that state's BET (discussed below) owing to the simplicity with which it can be computed and administered on the basis of the same information used for the state corporate income tax.

losses and deducting such items as dividends, interest and royalty income, and partnership income. SBT was payable on an estimated quarterly basis. Business investments in real property were fully deductible from the SBT tax base, as were investments in other property (equipment) considered located in Michigan. The tax base of multistate enterprises was apportioned on the basis of a formula that weighted the location of business property and payrolls equally.

Unlike the notoriously volatile corporate income tax, the SBT stabilized state revenues. It also reduced the distortionary effect of state business taxes by extending the tax base to encompass businesses organized in other than the corporate form. Moreover, it was easier to administer than corporate income tax. Although political pressures complicated the design of the SBT, Hines (2003) concluded that the tax was essentially sound in its design from an economic perspective. Since most new investments essentially escaped tax, much of the tax burden fell on "the excess profitability of local manufacturing, high-tech and other firms, the value of Michigan land, and the extent to which Michigan wages exceed competitive levels" (Hines 2003, 39).

However, as in Germany, there was considerable business opposition to the tax, largely because many businesses, particularly smaller ones, did not see why they should have to pay tax when they had no profits. More and more concessions were introduced over time, making the tax more complex. Since the benefit argument for the SBT was never prominent in Michigan, as the base of the SBT became more eroded – partly to offset the effects of the declining automotive sector – the tax came to be both excessively complex and unpopular. In 1999 its rate was reduced to 2.2 percent, with further annual decreases of 0.1 percent scheduled to take place until the tax was eliminated in 2020. Subsequent state revenue problems altered this schedule, however, and in 2002 it was decided that the then rate of 1.9 percent would be maintained until 2009, when the tax would be eliminated.

What actually happened, however, was that a new tax called the Modified Gross Receipts Tax was imposed (with some other taxes) to replace the SBT in 2007. As McIntyre and Pomp (2009) accurately note, this new tax is not very different from its predecessor(s), since it too is essentially an "apportioned" value-added tax based on the factor costs (value-added) apportioned to Michigan firms. In contrast to the SBT, however, this latest incarnation of Michigan's long-standing VAT is imposed on a destination and not an origin basis – that is, on imports but not exports – at a rate of 1 percent.

New Hampshire

New Hampshire's Business Enterprise Tax (BET) is also an apportioned VAT similar to that now in place in Michigan, although its base is determined by a more complex formula than the simple sales-apportionment rule used in Michigan.

Like the former Michigan Single Business Tax, the base of the BET is determined as the sum of the apportioned state share of the firm's national expenditures on wages and salaries, interest, and dividends, and hence is origin-based. Since BET is imposed at a low rate (0.5 percent), it is thought unlikely to create any significant disincentives for business use of capital and labour in the state. Indeed, like Michigan's current Modified Gross Receipts Tax, it is probably lower than a real business benefit tax intended to pay for the cost of public services provided to business would be. On average in the United States, the appropriate rate needed for this purpose appears to be closer to 2 percent (Oakland and Testa 2000).

Although several studies have argued that New Hampshire's BET provides at least a useful supplement to state corporate income taxes (Kenyon 1996) and perhaps even a useful replacement for such taxes (Arnold and Ardinger 2004),[12] as yet no other state has followed this model. A recent report in California, however, recommended that the California state corporate income tax be replaced by a "business net receipts tax," which is in effect like the VAT levied explicitly on firms rather than on final consumers (Cline and Neubig 2010). Unlike the other BVTs discussed here, however, the California proposal would have allowed some deductions for imports and taxed some exports and hence been a mixed (origin-destination) based tax.

Other States

A few other states have introduced some elements of a local business VAT into their tax systems in recent years. Notably, Texas introduced a "margin tax" in 2006 that imposes a tax at a maximum rate of 1 percent on a base determined as the least of three calculations – total sales revenue minus cost of goods sold; total revenue minus compensation; or 70 percent of total revenue (Sullivan 2008).[13] Although the first of these bases allows the deduction of labour costs in the production of goods (but not in service delivery) and does not allow the deduction of purchases of services from other firms, this tax is, like that in Michigan, a modified gross receipts tax that approaches a subtraction-based VAT. As in Michigan, for multistate businesses, the base is apportioned by sales.

Kentucky and New Jersey use a somewhat similar gross margin approach (revenue less the cost of goods sold) as an alternative minimum tax to the corporate income tax. Most recently, Oklahoma introduced a Business Activity Tax in 2010 that combines elements of a gross receipts tax with a subtraction method VAT (Luna, Murray, and Yang 2012). However, this tax was repealed in 2012.

The Italian IRAP

Perhaps the most important modern move to a local business VAT took place in Italy in 1998, when a new business tax – the *imposta regional a sulle activita*

12. Replacing provincial corporate income taxes by a BVT was suggested by Bird and McKenzie (2001), and Alberta (2006).

13. Businesses with revenue below $300,000 are exempt, and the rate then increases in steps from 0.2 percent on those between $300,000 and $400,000 to 1.0 percent for those with revenues over $900,000 (except for retail and wholesale trade, where the maximum rate is only 0.5 percent, with a similar graduated system).

produttive (IRAP) – replaced an existing regional income tax levied on business income as well as some other small taxes. This tax finances about one-quarter of all regional spending in Italy.

The IRAP is essentially a net income-type VAT on an origin basis. IRAP's base is calculated annually as the difference between gross receipts (sales revenues) and the cost of intermediate goods and services (purchases from other firms plus depreciation). There are specific rules for different types of financial institutions. Neither wages and salaries nor interest payments are deductible from the tax base. Outlays for capital goods are deducted in accordance with normal income tax depreciation schedules. Revenues are allocated among regions in proportion to labour costs incurred in each region. Most firms, including all types of business and self-employed activities, were initially subjected to IRAP at 4.25 percent, although regional governments may choose to levy an additional percentage point.

In principle, IRAP is neutral with respect both to the choice of organizational form and between equity and debt financing. Although an early study found that, on balance, it favoured capital expenditures over labour expenditures, this was essentially because the income tax depreciation schedules used for calculating the IRAP base were more generous than the appropriate economic rates for the depreciation of capital assets (Bordignon, Gianni, and Panteghini 2001).[14]

One reason for the initial adoption of IRAP was to bring Italian profit taxes closer to those in other European Union countries. For the same reason, in 2003 the national government decided to eliminate the tax, following the previous German model of "salami tactics" (slice by slice), beginning with the exclusion of 20 percent of labour costs from the base. However, it was left unclear how this essential source of regional finance would be replaced (Keen 2003). Despite several subsequent moves by the central government in the direction of abolishing the tax, the IRAP continues, perhaps because no similarly productive source of regional finance has been suggested as a substitute.

Although a 2008 law allowed regions to set the rate and even to some extent to alter the base, the law was never implemented (Longobardi 2013). Similarly, a 2011 law gave regions more discretion in setting IRAP rates and provided that IRAP revenues could be distributed on a destination basis beginning in 2013, using information on the location of final consumers from IRAP returns. In addition, regional revenue was to be distributed to municipalities on a per-capita basis. To date, however, these changes have not been implemented.

14. An interesting recent comparison between IRAP and CBIT, a comprehensive business tax originally proposed by the U.S. Treasury (1992), which essentially taxes the same base but allows the deduction of labour costs, found that IRAP was more contractionary (see also Joumard and Yokahama 2005, on Japan), but CBIT was more regressive (Manza and Monteduro 2010).

The IRAP has also faced legal challenges in the European Union. Several decisions by the Advocates-General of the European Court of Justice determined that the IRAP was not acceptable under European Union rules because its "VAT-like" characteristics mean that it is precluded under the VAT Directive, to which all European Union countries are required to conform. This Directive prohibits sub-central governments from imposing "value-added taxes."

These decisions were strongly criticized, however (Cnossen 2006), and in 2007 the Court, in an unusual move, decided not to accept the decisions of its Advocates-General, ruling that the IRAP was sufficiently distinct from the invoice-credit national VATs levied in the European Union to be acceptable.

Despite this legal victory, the Italian government shortly thereafter announced its intention to abolish the tax and reduced the basic IRAP rate from 4.25 to 3.9 percent. Nonetheless, although business taxpayers dislike the tax because it has to be paid even by non-profitable businesses and most political parties seem to want to abolish or at least reform it (Longobardi 2013), the IRAP survives.

The Hungarian HIPA

The local business tax in Hungary (HIPA) is levied at a locally determined rate of up to a maximum of 2 percent on a VAT-like base (sales revenue, excluding VAT, less the cost of goods sold, cost of materials, and cost of subcontractors). The tax has been criticized for favouring in-house production and the fact that, like any local business tax, it is more productive in richer than in poorer regions. Moreover, because the tax base is calculated on a very different basis from that of the corporate income tax, it is expensive to administer (Szalai and Tassonyi 2004). Nonetheless, HIPA remains the most important single source of local government revenue and, like Italy's IRAP, its legality has recently been reaffirmed by the European Court of Justice (Erdos 2009).

The French Territorial Contribution

France has long had a local business tax in the form of the *taxe professionnelle*. The base of this tax was essentially the rental value of a company's equipment plus its wage bill. In response to the argument that this base adversely affected employment, the payroll tax component was first reduced and then, in 2003, abolished; the loss of local revenues was offset by increased central government transfers.

The Fouquet Commission (2004) on the reform of the *taxe professionnelle* recommended elimination of this tax and phasing in a new local business tax to replace it. After considering a range of alternatives, the Commission favoured a form of value-added tax as the most economically effective, balanced, and equitable form of local business taxation. Business income taxes were felt to be too volatile a revenue source and insufficiently closely related to the costs borne by local authorities caused by business activities in their jurisdictions. The value-added base was said to provide both a more stable base and one that taxed all factors of production more evenly.

As usual, the major technical problem relates to the apportionment of tax base to different jurisdictions.[15] The Commission suggested that the number of employees, the wage bill, and the rental value of land were factors that should be considered in this connection. With respect to rates, the Commission favoured some, but not unrestricted, local freedom to set rates within limits. In reality, however, the only reform introduced in the *taxe professionnelle* in 2006 was to create a single ceiling of 3.5 percent of a firm's declared value-added, beginning in 2007. One reason for the minor nature of this reform was reportedly the adverse decisions of the European Court of Justice with respect to the Italian IRAP.

A few years later, however, France proceeded to introduce a new local business tax similar to the VAT in 2010 when the *taxe professionnelle* was replaced by the "economic territorial contribution" (Gilbert 2010a). This new tax has two components. One is based on the annual rental value of real property used for business purposes and the other on value added, defined as the difference between turnover (gross receipts) and the cost of goods and services used in the business. A tax of 1.5 percent is imposed on this value-added, although those with turnover less than 50 million Euros benefit progressively from partial relief until the tax vanishes at the 500,000-Euro level. Half of the proceeds of the local VAT go to the *départements* (the French equivalent to counties or provinces); the remainder is divided, roughly equally, between the other two levels of local governments – the regions and the municipalities (Beltrame and Oliva 2011). The French system is considerably more complex than this brief summary indicates.[16]

The Japanese Enterprise Tax

Although Japan is in most ways a highly unified country, it has a complex system of local government and a long tradition of local autonomy. Japan has 47 regional

15. Although other technical problems were identified, particularly with respect to the financial sector, the Commission argued that these were no greater than those associated with other forms of taxation and were not insurmountable. In fact, they favoured the value-added basis in part on administrative grounds because it had been used for several decades in calculating the *taxe professionnelle*. For taxpayers whose turnover exceeded 7.6 million Euros, for whom the "normal" tax base was less than 1.5 percent of value added, a minimal contribution was imposed to bring the tax to this level. For those whose calculated taxes exceeded a certain share of value-added (3.5 to 4.0 percent, depending on turnover), taxes were limited to this level, so that in 2003 more than half the tax was actually calculated on a value-added basis.

16. For example, there is a limit on the combined effective rate with respect to value-added of 3.0 percent for the total of the two components of the local business tax (the BVT plus the locally determined business property tax), and there is also a convergence process that both limits changes in the business tax rate and ensures that the rates within the new "federative" intermunicipal structures become uniform over time in order to reduce local tax competition (Gilbert 2012). For enterprises operating in more than one locality, the VAT tax base as calculated from the company accounts is allocated among localities essentially on the basis of employment (Gilbert 2010a).

governments, or prefectures, with populations ranging from 12 million (Tokyo) to a little over 600,000. In addition, it has about 2,500 municipalities (cities, towns, and villages). Both levels of local government have a broad range of functions (including education) and independently levy and collect many different taxes.

The main local tax on business is called the Enterprise Tax.[17] It is imposed both on corporations and on individuals engaged in a wide range of specified activities (including professional ones), although many primary-sector activities (farming, forestry, mining, etc.) are exempted, even those carried out by corporations. Japan's prefectures have long imposed the Enterprise Tax on most non-agricultural businesses, generally on the basis of income as computed for the national corporate income tax. The base attributable to the prefectures in which any taxpayer had a place of operation was determined by prorating the total tax base (for example, as reported for national corporate income tax), usually on the basis of the number of employees.[18]

Even when the Enterprise Tax was based on income, the local tax base was not identical to that of the corporate income tax, being more narrowly defined in some respects and more broadly defined in others, in an attempt to link the tax burden more closely to the benefits that local governments provide to businesses. The standard local Enterprise Tax rate was set nationally, with rates varying with taxable income up to a maximum of 9.6 percent on enterprises with offices in more than three prefectures and capital of more than 10 million yen, regardless of its taxable income. Prefectural governments collect the tax and may, if they wish to do so, impose rates up to 120 percent of the standard rates.[19]

Owing to Japan's prolonged recession in recent decades, an increasing number of companies on the taxable income basis reported persistent losses and hence paid no Enterprise Tax. To offset the loss of local revenue, a new form of local business tax was introduced in 2005 for corporations with capital greater than 100 million yen. The main reason for this change was to make the local business tax base less sensitive to economic fluctuations. In addition, it was argued that the new tax would better reflect the intended purpose of local benefit taxation by ensuring that

17. Most of the information in this section is based on Bird (2006), updated by Local Autonomy College (2008), and by information available as of January 2013 on the web pages of the Japan Ministry of Finance, Ministry of Internal Affairs, and Communications and other sources.

18. An alternative gross receipts tax of 1.3 percent was long used for electricity, gas, and insurance companies and prefectures were free to use other bases, such as the number of employees or the amount of capital.

19. Although an official study proposed that, apart from the property tax, local taxes should be administered by the National Tax Administration (Japan Research Institute 2006), the system has not been changed.

every company using local public services paid taxes whether it made profits or not.

This new tax base for larger enterprises has three components: income, value-added, and capital, but the key element in the new tax base is value-added, defined as the sum of salaries, net interest paid, net rent paid, plus (or minus) profit (or loss) in the year. If wage compensation in a year exceeds 70 percent of the total, the excess is deducted. This tax base is subject to a flat tax of 0.48 percent. In addition, a Capital Tax is levied on paid-up capital (amounts invested and capital surplus) at a rate of 0.2 percent. The rates of the income tax component were lowered for enterprises subject to these new levies, with a maximum rate of 7.2 percent. As before, prefectures are allowed, if they wish, to impose rates up to 120 percent of the standard rates: a few, such as Tokyo, do so. As with all local taxes on business, these taxes are deductible from taxable income in calculating the national corporate income tax.

In sharp contrast to most of the other cases discussed here, the principle of local benefit taxation of local business is formally acknowledged in Japan as the key argument shaping the form of local business taxation. Since businesses make use of such services as roads, ports, health services, and pollution control, it is argued that they should contribute to the cost of services and that this contribution should be related to the scale of their business activities.

The VAT component of the local Enterprise Tax is considered to be the best approximation to a benefit-related charge. This approach also makes local revenues more stable. However, no tax is perfect. Joumard and Yokoyama (2005) note, first, that although exempting small businesses reduces the burden on newly created companies with few or no profits, this exemption breaches the rationale of benefit taxation; and second, that although VAT reduces the volatility of local revenues, it does so by shifting some cyclical risk to firms and hence may exacerbate business failures during downturns.

Conclusion

The country examples provided in this paper are diverse and heavily influenced by their particular context and timing. However, although many aspects of the structure and effects of the BVTs discussed here call for further study, experience in Italy, Japan, and France demonstrates not only that a local tax based on value-added at the origin may be a sensible way of charging business for benefits obtained from local public spending, but also that such a tax may be introduced at the local level with no serious economic costs and some benefits in terms of improving the stability of local revenues.

In the Canadian context, it is important to distinguish a local BVT – a local tax, with the rate set locally – from proposals for "sharing" VAT (HST or GST) revenues with local governments or imposing similar destination-based consumption VATs at the local level, perhaps even with some freedom for local rate-setting. VAT sharing of this kind is no more than another intergovernmental grant, with the funding basis determined by a particular kind of formula.[20] No one, it seems, has ever considered allowing any local rate discretion in such schemes, owing to the complexity, costs, and distortions likely if hundreds of local governments had even semi-independent VATs.[21]

Nonetheless, local governments, especially (but not only) in large metropolitan areas, have important expenditure responsibilities. Both experience and theory suggest that they are more likely to exercise those responsibilities appropriately if they are also responsible for raising a significant amount of their own revenues, especially at the margin. Particularly in large metropolitan areas, introducing a potentially important and expanding revenue source like the BVT to replace other forms of business taxation might improve outcomes in both the public and private sectors. However, to avoid worsening economic outcomes by unduly penalizing investment and exports, it would be important to keep the rate of any such tax low – preferably at the level of a generalized user charge to finance the share of local public expenditures that benefit businesses. The idea is not to increase the economic cost of raising public funds, but to reduce it while simultaneously improving local accountability.

20. Japan imposes what is called a "local consumption tax" as part of its VAT, but all this means is that 25 percent of the collections of the central VAT is allocated to prefectures (the higher level of local government in Japan), which in turn allocate 50 percent of their share to municipalities: 75 percent on the basis of estimated territorial consumption, 12.5 percent on the number of employees and 12.5 percent on population. Prefectures in turn are required to allocate 50 percent of their share to their municipalities, with equal weight in doing so to the number of employees and population in part because data on consumption are not available at this level (Mochida, Horiba, and Mochizuki 2012). In 2010, Korea introduced a similar "local consumption tax," which is essentially simply 5 percent of national VAT revenue distributed on the basis of estimated regional shares of private final consumption spending.

21. The problem of how to deal with the thousands of existing local sales taxes in the United States has been a major concern in considering the possible introduction of a consumption VAT in that country: for a recent discussion, see McLure and Merrill (2013).

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